"The election was within the sole discretion of Honolulu, and might turn on any of the factors which influence a purchaser, e. g., the fluctuations in the selling price of oil, etc." Of what influence would the selling price of oil be if there were no oil to sell? The record, in fact, shows that between the date of the contract, October 3, 1927, and the date of the first optional annual payment, March 14, 1928, five wells were spudded in and completed; and between the latter date and the date of the second optional annual payment, March 14, 1929, seven more wells were completed. (R. 67-68). In practical effect, therefore, the election to make a payment or return the properties, and consequently the payment itself, did depend on whether oil and gas were being produced, and this the court below pointed out in its opinion. (R. 88).

In addition, it should be observed that Honolulu bound itself to the taxpayer to perform all work and labor required under the permits and leases transferred to it and to pay the royalties required thereunder to the United States, the original permittees, and the original lessors (R. 45-47), provided, however, that it might surrender to the taxpayer the properties or any part thereof, and be thereupon released of said obligation assumed with respect to the properties surrendered. (R. 60).

Moreover, Honolulu was required to render monthly statements of operations to the taxpayer (R. 59), with right in the taxpayer to examine the books of Honolulu and to have audits made of them (R. 59), and to come upon and examine any of the properties. (R. 61). And from the very beginning Honolulu was required to pay the taxpayer, monthly, the latter's reserved one-third of

the net profits from the properties after reimbursement of Honolulu for its expenditures under the contract, including the annual payments so far made to the taxpayer. (R. 46-54).

ARGUMENT

1. The first reason given by the Commissioner for granting of the writ is an alleged conflict between the decision of the court below and the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. Fleming*, 82 F. (2d) 324. The retained interest in the *Fleming* case, however, was an interest limited in aggregate amount, while the reserved interest here was a permanent one. In distinguishing *Palmer v. Bender*, 287 U. S. 551, the Fifth Circuit Court in the *Fleming* case stated (p. 327):

> "The taxpayer asserts that the money got from the production of oil was certainly subject to depletion because he had 'an economic interest' in the oil in the ground, and that what was paid in cash stands on the same footing as a cash bonus paid to a lessor, citing especially Palmer v. Bender, supra, decided since the Pugh case and involving the transfer of a lessee's interest for cash and oil payments. In Palmer v. Bender, however, the transferor reserved an additional royalty, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus or advance royalty."

Thus the Fifth Circuit Court in the *Fleming* case distinguished *Palmer v. Bender*, supra, on the ground that in the latter case the assignor was in effect a sublessor, having reserved a *permanent* interest in the leases trans-

ferred, while in the case before it the assignor was truly an assignor, the interest reserved being limited in aggregate amount, after payment of which the assignee's interest would continue but the assignor would have no interest left whatever. This very point by which the Fifth Circuit Court in the *Fleming* case distinguished *Palmer v. Bender* would have enabled that court to distinguish the case here and place it on all fours with *Palmer v. Bender*.

In a true assignment of a lease the assignor reserves no interest in the lease assigned. If he reserves any interest, whether it be of a portion of the term, or a portion of the premises, or some estate or interest in the premises, it is not an assignment but a sublease. *Barkhaus v. Producers' Fruit Co.*, 192 Cal. 200, 219 P. 435, 437. A transfer of a lease is a sublease, not an assignment, if the terms of the transfer are different from those of the original lease. *United States v. Hickey*, 17 Wall. (84 U. S.) 9, 13. By these tests the facts in the *Fleming* case, after the aggregate amount specified would be paid so as to leave no interest in the assignor, present, indeed, a pure assignment. By the same tests the facts here present a true sublease. The taxpayer's reserved interest here of one-third of the net profits after reimbursement of Honolulu for its expenditures was a permanent interest, just as in *Palmer v. Bender*. Thus the *Fleming* case, in the argument whereby it distinguishes *Palmer v. Bender*, in fact supports the decision here of the court below.

Not only in the reserved interest, but in the very payments as to which percentage depletion is claimed, the case here is wholly distinguishable from the *Fleming* case.

The payment in the *Fleming* case as to which percentage depletion was denied by the court, was a cash payment on the execution of the contract. Obviously that payment was not dependent on production under the contract. Here the two payments involved were not made on the execution of the contract but after possession had been transferred and production begun under the contract; and they were optional payments, dependent in necessary effect on the results of production. Obviously, too, in the *Fleming* case the cash payment itself depleted nothing. But each payment here involved reduced proportionately the amount the taxpayer would receive under its reserved interest in the net profits of production, since Honolulu was to be first reimbursed out of production for these payments before arriving at the profits one-third of which were distributable to the taxpayer. Thus in effect each payment here was but advance or minimum royalty.

The *Fleming* case, therefore, in its own argument, in the nature of the retained interest involved, and in the nature of the cash payment against which percentage depletion was denied, is entirely distinguishable from the case here.

2. The Commissioner, as a second reason for granting of the writ, says that the retained interest of the taxpayer in the net profits of production was not precisely the same kind of an interest as the retained interest involved in *Palmer v. Bender*, supra, nor as that involved in *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, nor as that involved in *Thomas v. Perkins*, decided by this

court June 1, 1937. The Commissioner's syllogism, paraphrased in homely terms, is this: an oak, an elm, and a poplar are trees; a birch is neither oak, nor elm, nor poplar; therefore, a birch is not a tree. Or does the Commissioner mean to imply that the precise types of retained interests involved in the three cases cited exhaust the types of interest classifiable as an economic interest in the oil in place? Indeed, in following and discussing *Palmer v. Bender* this court in *Thomas v. Perkins* stated that ownership was essential. But in its very reference to *Palmer v. Bender* this court in the *Perkins* case showed that ownership did not mean only technical ownership, but any economic interest in the oil in place depleted by production. That an interest in the net profits is depleted by production is obvious. That an interest in the net profits is an interest in the source of the profits, here the oil in place, has never been denied by this court. The expressions of this court on the point have, in fact, been to the contrary. *Irvin v. Gavit,* 268 U. S. 161, 167-168.

The very provision of the statute, moreover, granting the allowance of percentage depletion, Section 114 (b) (3), bases a limitation on the *net* income from the property; and the application of this limitation makes the Commissioner's contention mathematically impossible. Thus, suppose the operator's gross income from the property, after deducting all rents and royalties paid or accrued (*Helvering v. Twin Bell Syndicate,* supra), except its assignor's one-third share of the net profits, is $90,000, and its operating expense, $30.000. Of the net profit shown of $60,000, the operator's share is $40,000, and the assignor's share, $20,000. According to the Commis-

sioner's contention percentage depletion allowable to the operator would be determined as follows:

1. Gross income (after deducting rents and royalties paid or accrued, *except* assignor's one-third share of net profits)	$90,000	
2. 27½ per cent thereof		$24,750
3. Operating expense	30,000	
4. Net profit	$60,000	
5. Operator's share (two-thirds)	$40,000	
6. 50 per cent thereof		$20,000
7. Percentage depletion allowable to operator (the lesser of items *2* and *6)*		$20,000

Thus in arriving from gross income to net income, with respect to the operator, the Commissioner cuts out (between items *4* and *5* above) the assignor's share of the net income, *without any accounting at all.* The only possible way to apply the statute is to deduct the assignor's share of the net income in arriving at the *operator's* gross income, so that by deducting operating expense, the *operator's* net income is determined, as follows:

1. Operator's gross income (after deducting rents and royalties paid or accrued, *including* assignor's one-third share of net profits)	$70,000	
2. 27½ per cent thereof		$19,250

3. Operating expense	30,000	
4. Operator's net profit	$40,000	
5. 50 per cent thereof		$20,000
6. Percentage depletion allowable to operator (the lesser of items 2 and 5)		$19,250
7. Percentage depletion allowable to assignor, 27½ per cent of $20,000, his share of net profits		5,500
8. Total depletion allowable to operator and assignor, equal to 27½ per cent of their combined gross income of $90,000		$24,750

Thus the assignor's share of the net income must be treated, as to the assignor, as both gross income and net income from the property, as any royalty would be. No other solution consistent with the statute is mathematically possible.

3. The Commissioner assigns as a third reason for granting of the writ the fact that there are pending his petitions for certiorari in *Helvering v. Bankline Oil Co.*, No. 387, and in *Helvering v. O'Donnell*, No. 406. No. 387 involves percentage depletion, but the precise issue there seems to bear no relation whatever to the issue here. No. 406 does involve the question whether a share in the net profits is an interest in the source of the profits, but is otherwise unrelated. The petition in No. 406

urges the importance of the question as a reason for certiorari. But percentage depletion is a mere statutory rule of thumb. *Helvering v. Twin Bell Syndicate,* supra, p. 221. If the Commissioner is not satisfied with it as it is, certainly Congress has the power to revise it.

Conclusion

WHEREFORE, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * * * *

"(b) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

* * * * *

"Sec. 114. Basis for Depreciation and Depletion.

* * * * *

"(b) Basis for depletion.—

* * * * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."